

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Diann Shipione on June 21, 2006

DATED: July 31, 2006

On June 21, 2006, Benito Romano, in Willkie Farr & Gallagher LLP's capacity as Counsel to the Audit Committee, and Lynn Turner of the Audit Committee, interviewed Diann Shipione. Ms. Shipione was not represented by counsel during this interview, but her husband, Pat Shea, a lawyer, was present as her representative. Also present were William Haegele of KPMG, and Sharon Blaskey and Ray Sarola of Willkie Farr. This interview took place in a conference room in the Hiatt Regency Hotel in La Jolla, California and lasted approximately two and one-half hours.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with Ms. Shipione, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Mr. Romano began the interview by informing Ms. Shipione that Willkie Farr represents the Audit Committee, and not her personally. Mr. Romano stated that the notes prepared during the interview would be treated as confidential work product, but the Audit Committee controls the privilege and could waive it at any time. When the Audit Committee's Report is published, the privilege attached to the interview notes will likely be lost. Mr. Romano asked Ms. Shipione to try to be as accurate as possible in her answers, and stated that the summary memorandum of this interview might be made public.

Mr. Turner asked Ms. Shipione if she had any questions, and she asked if Willkie Farr represented the City. Mr. Romano answered that Willkie Farr represents the Audit Committee, which was created by a resolution of the City Council to provide services to the City. Mr. Turner added that, according to the Council's resolution, the Audit Committee has the same powers of that of a public company, and is similarly independent. Mr. Turner stressed that the Audit Committee was focused on being independent, since it is investigating the whole City. Ms. Shipione then asked to whom the Audit Committee reports. Mr. Turner replied that the Audit Committee does not report to the auditors; the auditors report to the Audit Committee. He stated that Mayor Dick Murphy, City Manager Lamont Ewell, and City Attorney Michael Aguirre signed the Audit Committee's engagement letter, which the Council voted to approve in a public meeting.

Ms. Shipione asked the purpose of the notes of the interview. Mr. Romano responded that the notes were not verbatim, but were meant to capture the statements made

during the interview. Ms. Shipione stated that she was not going to answer questions relating to government investigations, and Mr. Romano said that was fine, but also informed her that Willkie Farr and the Audit Committee were cooperating with government agencies.

Callan

Mr. Romano said that during the course of this investigation, he had read Ms. Shipione's correspondence and wanted to address her concerns in the Audit Committee's Report. In order to do this, he explained that he needed to ask Ms. Shipione to clarify some of her past comments.

Mr. Romano read to Ms. Shipione the following statement from her May 23, 2002 letter to Fred Pierce (Exhibit 1):

Concerns regarding what appears to be a regular practice of recommending less than fully experienced or successful investment managers after manager searches, which should have identified far better candidates..., the lack of clarity regarding specific trade commissions and confirmation of 'best execution' on trades..., [t]he response from our consultant has been reluctant, slow, and inadequate.

Mr. Romano noted that he had seen elsewhere references to Ms. Shipione's concerns with investment managers at SDCERS, and asked her to explain these concerns. Ms. Shipione responded that she addressed these concerns about SDCERS's investments in a June 7, 2002 letter to Richard Vortmann and Mayor Murphy. Mr. Romano then asked Ms. Shipione to explain the basis for her conclusion that Callan had conflicts of interest in performing services for SDCERS. Ms. Shipione responded that prior to her appointment to the SDCERS Board, she had heard of Callan and had assumed they were very good. She stated that when she first joined the Board, Callan had the appearance of being well-run and she was impressed with the meetings that were led by its consultants. As time passed, however, she noticed suggestions and recommendations by Callan which raised concerns because of several investment managers who were underperforming their benchmarks. Callan was responsible for monitoring these investment managers, and did not recommend reassessing or terminating them, despite their underperformance over an extended period.

Ms. Shipione explained that she received information from Callan through quarterly statements that it provided to the Board. These statements contained lists of the investment managers selected by Callan for SDCERS. Ms. Shipione stated that, at that time, she did not believe there was much of an issue with Callan, and that she was only trying to acquire information regarding the underperforming managers. She noted that other trustees shared her concern about underperforming managers, and that she had asked the Board's staff and the investment consultant about this issue. Over time, Ms. Shipione noticed her questions were not being accurately responded to at Board meetings, and not reflected in the Board's minutes. She wrote letters to create a record that she had questions regarding the underperformance of certain managers. She stated that there were economic relationships between Callan and its investment managers and it was not clear to her why underperforming managers were allowed to continue investing in the SDCERS fund.

Mr. Romano asked Ms. Shipione how she learned of these economic relationships, and she responded that she discovered some of them when she contacted the investment managers directly to learn the history of their relationship with SDCERS. Ms. Shipione stated that she did not know whether the protocol was for her to direct her questions through Callan, but she recognized that SDCERS staff had instructed the investment managers not to speak with staff directly. She noted that trustees were supposed to go through staff when they wanted information, and didn't know whether Callan felt "chummy" with her.

Mr. Romano asked Ms. Shipione if the investment managers she contacted had disclosed relationships between them and Callan. Ms. Shipione said that Trinity did not, but Oppenheimer disclosed a "significant" relationship with Callan - namely that Oppenheimer had hired Callan to help them remarket their services to institutional funds. Ms. Shipione asked both Trinity and Oppenheimer the magnitude of their relationships with Callan, and both told her this information would not be disclosed. She stated that she just wanted to know if any of these relationships were causing Callan to be biased in its advice to the Board. She again noted that multiple investment managers were underperforming and she wanted to know why.

Mr. Romano asked Ms. Shipione if SDCERS had a policy regarding performance rankings for managers, or a policy that required Callan to disclose this information. Ms. Shipione responded that she did not know, and that she asked this information of Callan directly, first through the plan consultant to SDCERS and later through his supervisor. She thought it was possible that the plan consultant did not understand the issue and that his supervisor might have been able to provide more disclosure. She stated that she had always heard positive things about Callan "from a distance," and she was trying to determine if this was a problem with Callan itself, or a problem with a specific person at Callan. Ms. Shipione said she was just trying to do her job as a trustee.

Mr. Romano asked if Callan had the responsibility to remove underperforming managers, and Ms. Shipione replied that she considered this to be included in its "monitoring" duties. She stated that Mercer had confirmed her understanding of this point when it reviewed Callan and concluded that Callan should have been making statements concerning whether investment managers should be hired or fired. Ms. Shipione felt that if Callan's policy was to keep underperforming managers, such as Lincoln Capital, that Callan should so inform the Board. Callan recommended that the Board use Lincoln Capital and continued to so advise the Board, even when Lincoln Capital began to lose some major clients. The Board later terminated its relationship with Lincoln Capital, but Ms. Shipione had since heard of some kind of relationship between Callan and Lincoln Capital, but did not have any further information on that point.

Ms. Shipione mentioned that she learned Callan had been directing a portion of its brokerage through the Bank of New York, and feared this directed brokerage might have created a bias. She stated that some directed brokerage took place during 2002. She learned this information from investment managers, since staff was not "forthcoming" with this information. Mr. Turner asked whether staff informed her which banks were executing the trades and at what cost. Ms. Shipione replied that the SDCERS CAFR contained lists and dollar amounts, but there was no acknowledgement from staff about a directed brokerage program. Ms. Shipione stated that she asked staff about this issue and they denied the existence of such a program. She then

asked the money manager and Retirement Administrator Lawrence Grissom, who also denied the existence of a directed brokerage program. Eventually, certain staff members admitted this program existed. Again, Ms. Shipione explained that she was making inquiries simply to try to understand how SDCERS's investments were handled.

In addition to the issue of underperforming managers, Ms. Shipione also stated that there were discrepancies in the dollar amounts between certain reports and CAFRs for the same time frame. She explained that she had heard that there was a one-quarter lag with real estate valuations, which she said she understood, but that the lag was not due to the use of prior consultant reports, as she would have assumed, but instead was due to the use of an inflated, \$40 million value which was not documented. She stated that the use of this value resulted in minimizing a reported loss in this asset class. Ms. Shipione also mentioned other issues, such as the pooling of cash with the City, measuring hedge funds against inappropriate benchmarks, and the lack of risk management by Callan, but did not provide any further specifics on these issues. She stated that during the late 1990's, she felt that SDCERS was missing out on better returns during good years, and was worried what would happen when the market fell. She also expressed a concern about whether SDCERS was accurately reporting its financial condition to interested parties.

Mr. Turner asked Ms. Shipione if she ever saw any documented information regarding payments or kickbacks from investment managers to Callan. Ms. Shipione responded that she did not recall seeing anything that specific, and stated that her concerns extended even to any legally-attained profit that Callan received from managers (such as from managers who purchased services from Callan), that might impair its advice. She stated that there is nothing inherently wrong with these economic relationships; the question was whether these relationships were adequately disclosed to the Board such that the Board could evaluate Callan's advice.

Mr. Romano asked Ms. Shipione what conclusion she ultimately reached regarding her concerns about Callan's practices. She replied that Callan provided to her a list of managers. The list had three columns, representing three categories of economic relationships, and each manager was ascribed a category. Callan did not disclose dollar amounts, which Ms. Shipione said was important because if the dollar amounts were low, there would have been less risk of bias. This document was e-mailed to her by Callan sometime in 2002. Ms. Shipione stated that she was still concerned that there might be other relationships, such as if Callan consultants recommended a given manager for a different fund, Callan might not want to fire that manager from the SDCERS fund due to that relationship. She stated that her biggest concern in this regard was a lack of internal controls by SDCERS in general. She said that SDCERS seemed to her to be "loosely-run." For example, she mentioned that she occasionally stopped by SDCERS offices and, when she did, noticed few people working. Also, during one of these visits, she asked staff about the process for ascertaining when a participant dies, and was told that they did not have a procedure other than reading the obituaries. She felt that this was a problem, and it raised concerns about "what else is going on here."

Ms. Shipione stated that she raised concerns to the SDCERS Board about the Board's contracts with all its consultants, and requested disclosure from them regarding any potential conflicts. She stated that she had mentioned the conflict issue when the Board hired

Mercer, for example, but did not recall whether the Board had a policy for dealing with disclosure of conflicts. She stated that, in 2002, City-wide conflict policies were developed in conjunction with both the creation of the Ethics Commission and discussions regarding conflict issues and Government Code Section 1090, sometime in 2002.

"Funny Accounting"

Mr. Romano next read Ms. Shipione a statement she wrote in a December 31, 2002 letter to Lamont Ewell (Exhibit 2): "The Municipal Code has additionally been abused to allow 'Funny Accounting' practices that hide liabilities labeling them as 'contingent' and/or manipulating them off the books through 'reserve accounts.'" Mr. Romano asked if this statement was in reference to the Waterfall provisions in the Municipal Code, Corbett payments, and the use of reserve accounts to pay various benefits. Ms. Shipione replied, "to a degree." She explained that the Corbett contingency "might fall under this," because it is not contingent; it accrues if not paid. Another issue is healthcare costs that are reimbursed to members directly for payments they made out-of-pocket. She stated that she believed this approach used pension assets to pay non-pension benefits in violation of IRS regulations, which was what she meant by "diverting assets." Mr. Turner asked if there were other benefits she was referring to when she wrote "contingent." Ms. Shipione responded that the 13th Check benefits had been paid for twenty years, but were not accurately reported. She stated that the Board had been advised of the possibility that these payments could be considered vested rights, and that SDCERS would have been forced to continue to pay them. Ms. Shipione said that if the system had to make these payments, it should have reported them.

Ms. Shipione stated that she was concerned that the system was paying out assets instead of keeping them in the system where they could earn an 8% return, and that the system was not funded well enough to pay all the benefits that had been granted. She said that she believed the system was not funded properly and SDCERS was not reporting a liability for benefits that had to be paid. Mr. Turner asked her if she was specifically referencing non-disclosure in the SDCERS CAFR, and Ms. Shipione replied that she meant CAFRs and valuations in general. She stated that the system should accurately report benefits it was paying and the assets in the system. She noted that DROP (Deferred Retirement Option Plan) assets and liabilities were held outside the system, and she never understood why, since it seemed to her that all assets and liabilities should have been included.

Mr. Turner asked Ms. Shipione if she was ever told that GASB allows pension systems to exclude retiree health care payments. She replied that she was not told this, and that she knew GASB 25 and 26 discuss conditional benefits, which she believed related to COLA. She explained that COLA payments are made if there are sufficient earnings, but do not accrue, unlike Corbett payments which accrue. Regarding retiree healthcare, Ms. Shipione stated that she only knew that the pension system should not have been using system assets for non-pension benefits, and noted that law firms had given opinions advising that this structure violated constitutional or other requirements.

Ms. Shipione then gave the Audit Committee slides from a presentation that Ice Miller made to the Board on June 16, 2006. She stated that, according to the presentation, the IRS is very concerned about the redirection of these assets. A new ethics representative hired by

Mayor Jerry Sanders was at this Board meeting and asked Ice Miller if it was clear that this funding structure was in violation of federal law in 1992, and Ice Miller responded that it was. Ms. Shipione called this issue "well-trodden," and stated that people knew the structure was in violation of law. She said that Mr. Grissom said the IRS would only "slap [the Board's] hand" and force it to change going forward. She stated that she was not aware of any analysis ever conducted regarding why assets were diverted to pay healthcare premiums but not to reimburse out-of-pocket payments for healthcare by retirees.

"The Slide"

Mr. Romano asked Ms. Shipione about a presentation she gave to the Port Authority in August 2003, in which she used a PowerPoint slide to explain the pension system's funding status. He stated that he understood she was asked to speak at a Port Authority meeting, but that a controversy arose regarding a slide she used, which she obtained from SDCERS staff. He said the slide apparently contained different numbers than a similar slide that was used in the SDCERS presentation to the Rules Committee. Ms. Shipione responded that she did not recall the specifics of this issue, but she did recall difficulty in obtaining information regarding the dollar amount of the underfunding at that time. She said that she understands now that both the numbers on her slide and those on the slide from the Rules Committee presentation were "very low." She did not recall exactly why she was asked to speak to the Port Authority, but thought it was probably due to the concerns she had raised regarding pension issues.

Mr. Romano noted that the slide used in the presentation to the Rules Committee showed a smaller underfunded amount than the slide used in Ms. Shipione's presentation to the Port, in which she argued that the underfunded amount was arbitrarily lowered. Mr. Romano asked Ms. Shipione how she arrived at the conclusion that the underfunding amount was arbitrarily lowered to reduce the impact of the funding deficit. She responded that she had talked with SDCERS Actuary Rick Roeder regarding his method of calculating the actuarially determined values for the system. Mr. Roeder told her that he uses a calculation that one might not assume when hearing "actuarially determined rates." Ms. Shipione stated that she understood his method artificially reduced the amount of underfunding by lowering the difference between what the City actually paid and what it was required to pay under MP1 and MP2. She explained that Mr. Roeder assumed, for the purposes of his calculations, that the City had made its full ARC contribution the prior year. She stated that if he had instead calculated the underfunding using the amount the City actually paid in the prior year, the underfunding and the amount the City owed that year would have been higher. Mr. Turner asked Ms. Shipione how she learned this information, and she said that Mr. Roeder told her, and also wrote about his methodology in a letter to SDCERS.

Mr. Romano asked Ms. Shipione whether there was any other information she had, besides her communications with Mr. Roeder, that made her think that the underfunding values were manipulated, rather than being mistakenly recorded. Ms. Shipione said that, to clarify, she was not sure that communications with Mr. Roeder triggered her conclusion that numbers were being manipulated. She stated that there were many elements of the system that seemed to diminish liabilities and inflate assets. This was a pattern, and occurred too often to be simple chance. She could not recall any additional specifics regarding this issue.

Mr. Romano showed Ms. Shipione an e-mail from Jeffrey McEntee to Paul Barnett, dated August 12, 2003, which attached a copy of Ms. Shipione's PowerPoint presentation for the Port meeting (Exhibit 3), and asked whether this refreshed her recollection of the events regarding her Port presentation. She said that she would have to look back at her own e-mails regarding this issue and could not recall any additional specifics at that time.

Mr. Romano showed Ms. Shipione a letter she wrote to Mr. Pierce, dated September 7, 2003 (Exhibit 4), regarding their disagreement over her use of certain slides. Mr. Romano asked if this document helped Ms. Shipione recall why there was a difference between the values on the two sets of slides. She responded that she could not recall specifics, only that the way Mr. Roeder was calculating the actuarially determined numbers had the effect of reducing the amount of underfunding. She recalled a Board meeting in which Mr. Vortmann asked Mr. Roeder what would have happened if he did not use the assumption that the City had paid the full ARC in a preceding year, and Mr. Roeder responded that the City's contribution rates would have been higher. Mr. Romano asked if the calculations were presented as a legitimate professional debate among actuaries. Ms. Shipione did not remember how this issue was presented to her, but recalled that it was clear Mr. Roeder's assumptions were not reflecting reality, and that her own common-sense was that his method artificially reduced the underfunding from MP1. Mr. Romano asked if Mr. Roeder mentioned this when presenting SDCERS's actuarial valuations. Ms. Shipione said no, and that this was specifically related to the method he used to calculate the rates against which the City's contributions were being measured. She stated that she didn't know exactly how Mr. Roeder was making his calculations, but he did have a method for calculating the system's underfunding. Ms. Shipione stated that Mr. Roeder told her he had never calculated the ARC. She said she would provide the Audit Committee with documentation she had concerning this issue, and also the issues regarding Callan.

One-Year Lag

Mr. Romano read Ms. Shipione the following statement from her September 14, 2003 letter to Fred Pierce (Exhibit 5): "The SDCERS Presentation to Rules further misrepresented the true impact of the shortfall by incorporating, without full disclosure, the '1 year-lag' that allows the City to pay its already deficient contributions one year in arrears." Ms. Shipione stated that she had a letter from Mr. Roeder on this issue. She explained that the lag was a situation where, for example, the City's contribution pursuant to the actuarial valuation dated June 2005 is not made until FY07. As a result, the plan is not generating investment return on these assets, which creates a greater deficit. Mr. Romano asked if this lag was always present, and Ms. Shipione replied that she did not know.

Transfers from Enterprise Funds

Mr. Romano asked Ms. Shipione to explain her comment in an October 29, 2004 memorandum to Steve DeVetter of KPMG (Exhibit 6), that transfers "to the General Fund from the City's Enterprise Funds or other special use funds...need to be audited to confirm that these revenue streams are legitimate and sustainable...and that the transfers comply with local, State and Federal law." Ms. Shipione responded that she was referring to the fact that the enterprise funds, such as water and sewer, are supposed to be separate from the General Fund and "run

within their own revenue streams.” She noted that the transfer of money from one fund to another for the purpose of paying for services received by the transferring fund is understandable, but that the rates need to be legitimate. If other funds were charged more simply for the purpose of balancing a deficit in the General Fund, this would be a problem. She mentioned that the City had an unallocated Rate Stabilization Fund, the legality of which has not been tested in California. Mr. Romano asked if the Rate Stabilization Fund was a separate issue from the transfers, and she replied that it was.

Mr. Romano asked if her concern was that she wanted to ensure that the percentages of services that were charged to various funds were correct, and Ms. Shipione confirmed that it was. She said her concern sprung from the fact that if there was a diminishment of revenues entering the General Fund, this might impair its ability to make pension payments.

Mr. Romano asked Ms. Shipione to clarify her concerns with the Rate Stabilization Fund. Ms. Shipione stated that the City disclosed the existence of this fund, just as it disclosed certain “rate-hike improprieties” relating to Proposition 218, but she did not understand why simply disclosing an inappropriate scheme made it acceptable. She had asked Terri Webster in January 2003 about transfers from the water fund to the General Fund, and Ms. Webster said that it was illegal to transfer money in that manner. Ms. Shipione explained that she wanted someone to look at the agreements regarding fund transfers, such as SLAs, and make sure the law was being followed.

Ms. Shipione also recalled hearing information regarding the City Attorney’s Office billing for work that it should have, but might not have, performed for the Water Department. Mr. Turner asked Ms. Shipione where she heard this information, and she said that in 2005 she received a “quasi-anonymous” package of documents containing related information at her house (the package contained a return address, but no name). She stated that this information was “specific” regarding pressure within the City Attorney’s Office to bill the Water Department for legal services. Mr. Haegele asked Ms. Shipione what timeframe this alleged activity spanned. She responded that she heard that it took place over a long timeframe and was an ongoing practice. She said there was a reference to the fact that the person being pressured was told that the City Attorney’s Office had been engaged in the practice of billing hours to the Water Department for investigating water fraud over a period of time. Mr. Romano asked if the allegation was that fictitious entries were being recorded, and Ms. Shipione stated that the documents suggested this, but she did not follow-up and investigate this issue.

Mr. Romano asked Ms. Shipione if she had provided the documents regarding alleged improper billing to the Department of Justice. Ms. Shipione initially replied “no comment,” but then stated that “I provide everything I have to everyone.” Mr. Haegele asked her what she did when she received the documents, and she said she may have mentioned them to the City Attorney’s Office. Mr. Romano asked her to clarify whether she was referring to the current City Attorney Michael Aguirre, and she confirmed she was. She said that she could not remember if she gave him these documents, but again stated that she “turns over everything to everyone,” and said she was willing to provide these documents to the Audit Committee. She had heard that the people who got promoted at the Water Department are those that “hide the ball; hide the cost,” and that such behavior is considered to be appropriate. She observed that it

is difficult for City employees to speak out or raise issues because they are often frightened by the “cultural issue of secrecy, of withholding information.” In her experience, when someone were to ask a question, material information would be omitted from the answer if the question was not specific enough. Ms. Shipione described the City as “a very difficult environment to get reality or the truth,” and she personally faced this challenge on the SDCERS Board.

Mr. Haegele asked Ms. Shipione if the documents she received led her to believe that the misallocation of funds through these inter-fund transfers was purposeful. Ms. Shipione replied that she believed the misallocation was purposeful, and that the City’s auditor had commented that the “sewer disclosures were a mess.” Ms. Shipione said that there were “hidden reserves that only a few people knew about.” Mr. Haegele asked if she knew where the direction came from to engage in these practices, and Ms. Shipione said that names were mentioned on City Attorney’s Office documents, but she did not know much beyond that.

Mr. Romano asked Ms. Shipione if she had any other information that led her to believe that certain transfers between funds were improper. Ms. Shipione recalled receiving an email from Ms. Webster in 2003, the tone of which was “it’s too complicated, you wouldn’t understand.” Ms. Shipione had also heard from the Board’s President or General Counsel that “we have immunity,” even if we make mistakes.

Water Rate Compliance

Mr. Romano read Ms. Shipione the following statement which she wrote in her October 29, 2004 memorandum to Mr. DeVetter (Exhibit 6): “The City does admit it did not comply with State law/requirements when it increased water rates in FY 2002 and 2003 and further admits it may be challenged for the rate increases effective 2004, 2005, and 2006.” Mr. Romano asked Ms. Shipione to explain her belief that the City did not comply with state water rate requirements in 2002. Ms. Shipione responded that she would need to look at City documents to verify this information, but believed that water rates needed to be property-related. Ms. Shipione could not recall whether she read this information in the City’s 2004 Voluntary Disclosure or in another document. She said she would have to check her files for information regarding this claim.

Mr. Romano next read Ms. Shipione her statement, from the same memorandum, “The City has recognized, in the past, though not necessarily in its financial statements, the likelihood that the sums collected, if challenged in court, would be ordered returned as being a disguised ‘tax’ not in compliance with 218 and other State laws.” Ms. Shipione stated that she was concerned with water and sewer fees, and also franchise fees with utility and cable companies. She explained that her concern with Proposition 218 was that money might have been moved between funds improperly, and she wanted to make sure that transfer fees were actually used for the purpose listed. Mr. Romano asked Ms. Shipione if she had any reason, besides knowing that money was transferred between funds, for her concern that the transfers might have been improper. Ms. Shipione replied that her concerns came from a lack of internal controls in the pension system generally, the diversion of pension funds for other purposes, the Board’s disregard of advice that certain actions violated the constitution, and the “repeated stonewalling and lack of interest for my concerns and a comprehensive audit.” Ms. Shipione

said she was worried this lack of attention to internal controls was "bleeding over" to the City because some of the City employees sat on the SDCERS Board.

Payroll Issues

Mr. Romano read Ms. Shipione the following two statements from her October 29, 2004 memorandum to Mr. DeVetter (Exhibit 6):

It is important to have accurate payroll numbers...artificial manipulation of payroll numbers could result in intentional underfunding of the pension plan...[and] [t]he City of San Diego does not provide accurate payroll data;

Because the City maintains the employment records and manages all payroll issues, and actively participates in the structuring of all the back-loading pension underfunding deals (including the artificial limitations on Actuarial assumptions contained in the recent Gleason-Wood settlement agreement..., the responsibility for much of the structure, and most of the source information, is within the ambit of the City audit review.

Mr. Romano asked Ms. Shipione if she had any other information, besides comments by April Boling, that led her to believe that payroll numbers had been manipulated. Ms. Shipione said that she had some concerns which resulted from her inability to locate a payroll line item in the City's budget. She had asked someone in the City (she couldn't remember who) about this information, but was "stonewalled." She then asked Mr. Roeder where he acquired the actuarial payroll number that he used in his calculations, but the number he used was lower than the number used by the City. She was concerned because she couldn't find a source for the City's payroll number, and said that someone needed to confirm this amount. Ms. Shipione had also heard that blank 1099 forms, or 1099 forms without IRS withholding, had been issued to pensioners, but she did not have specifics on this issue. She explained that because pension numbers were calculated from the City's payroll number, it would be a problem if that number was inaccurate.

Mr. Romano asked her about her conversation with Mr. Roeder about the payroll numbers, and she said he told her he relied on staff for this data. Mr. Roeder had explained that normally the actuary would determine the dollar amount of the plan sponsor's (i.e. City's) required contribution in a given year, calculate it as a percentage of payroll, and tell the sponsor the percentage it needed to contribute each pay period. In San Diego, however, because the pension system received a lump-sum payment at the beginning of the year, it was important to have accurate payroll information for that year. Ms. Shipione expressed her concern that the system could not calculate the true liability for pensioners without accurate payroll data. Ms. Shipione also mentioned she learned that payroll checks had been issued to pensioners who had died. She explained that she was alarmed by this information because some people had been improperly paid for up to ten years. Ms. Shipione said that she had contacted the Auditor's Office to get information regarding this issue, but her efforts were "blunted," and she got a "bad response" to her request to see the results of the Death-Match Audit. Ms. Webster told her to file

a public records request, which she did, but felt that it was a problem that she had to take such steps, given that she was a trustee of the pension system trying to do her job.

Mr. Romano asked if she recalled being asked to discuss the Death-Match Audit and declining, and she replied that she did not recall this. She said that the issue was "quasi-resolved" because the City disclosed that there were some problems with paying dead pensioners. Ms. Shipione said that the problem with raising her concerns with the retirement system was that she was being forced to prove herself right over and over, and it took a lot of time and energy. She said that the media "loved" the death-match issue, but she believed that many of her other concerns were much more material. She said that it was disconcerting because this was a traditional means of fraud, and if this was allowed to persist, there might have been other problems as well.

Comprehensive Audit of SDCERS

Mr. Romano read Ms. Shipione her statement from the October 29 memorandum to Mr. DeVetter, that "SDCERS has never been comprehensively audited." Mr. Romano asked if she was referring to a top-down audit which would include, among other things, operations and investments. Ms. Shipione said yes, and that the benefit delivery system should be audited as well. She stated that the audits that had been done were limited in scope, and were "less than comprehensive" as a result.

Commingling Cash with City

Mr. Romano read Ms. Shipione her statement from an e-mail she wrote to Benito Romano, dated April 30, 2006 (Exhibit 7), that:

SDCERS has pooled its cash with the City for over a decade.
SDCERS has not reconciled the cash to monthly bank statements
since at least 2003...This alone makes it impossible for SDCERS
to report a total portfolio investment performance return that
complies with any industry standards.

Ms. Shipione explained that the City and SDCERS were commingling cash, other than cash held by investment managers. She said that there was a reconciliation reflecting cash going to investment managers in which such cash was counted as an asset, and there was a reconciliation reflecting SDCERS cash which was held in the Treasury. She did not know why the pooled cash was kept in a commingled account, but she believed there were pooled cash accounts with the City. Ms. Shipione stated that she was not sure why Brown & Armstrong, SDCERS's independent auditor, raised this commingling as a material issue because the CAFR indicated that this only involved \$8 million, which was not a substantive amount for SDCERS. She speculated that perhaps Brown & Armstrong thought that amount was greater. Brown & Armstrong stated that SDCERS asserted that it had "x" dollars in a pooled account, but that this value was not reconciled on a monthly or yearly basis. Ms. Shipione said that she was concerned that this cash might be double-counted by the City and SDCERS.

Mr. Romano asked Ms. Shipione if her basis for this concern was the Auditor's material weakness report, or if she had other supporting information. She responded that at the

end of the year, the system would sell certain assets, but while the City valued these items using the settlement date of the sale, SDCERS used the trade date to value them. She tried to determine how this asset liquidation was accounted for, but when she asked Doug McCalla (SDCERS Chief Investment Officer), his answer did not make sense to her. Her concern was that these assets might be double-counted as both securities and cash. Mr. Haegele asked why certain assets were liquidated instead of transferred to a different asset class. Ms. Shipione replied that this two-step process was necessary because of the way the system values assets. The process was an unusual one that Mercer questioned. Ms. Shipione said that SDCERS's new actuary has stated that this accounting process needs to be changed because it provides an opportunity to artificially inflate asset value. This concern was echoed by Mr. Roeder, who wrote a letter stating that this accounting practice was not appropriate because the value of investments could be artificially modified. Ms. Shipione said that because of the way SDCERS valued investments, the gain on one particular transaction could be applied to the entire portfolio.

Mr. Haegele asked Ms. Shipione if the eight percent return that goes into the Waterfall was return on a cash basis if certain assets were sold. Ms. Shipione replied that this "return" number represented gains, interest, and income, but not realized returns. She had concerns about the accuracy of these return calculations with regard to external cash flows. Since cash was transferred among investment managers, if returns are calculated each time assets are transferred, this method would be accurate. However, if returns were only valued certain times for certain asset classes, it would be inaccurate. She said that, in reality, SDCERS had large amounts of money in the market at all times, but it was not clear how SDCERS reported these assets.

"Tortured Interpretation" of Municipal Code

Mr. Romano read Ms. Shipione her statement from her December 31 letter to Lamont Ewell (Exhibit 2) that the funding deficit was due to "a tortured interpretation of the Municipal Code used to hide unfunded liabilities so City contributions would be artificially reduced...to remove assets from the plan to pay contributions or benefits, thus preventing assets from being reinvested in an actuarially sound manner." Mr. Romano asked if this comment referred to the removal of plan assets and income through the use of the Waterfall, and Ms. Shipione said that it did, and also included retiree health care payments. She clarified that she might have been referring to the idea of "surplus" earnings and the use of the Municipal Code to "do things that were not appropriate." For example, she said that an ordinance created a trust fund for retiree health care, but that this violated the Internal Revenue Code. There was a second health care trust proposed, but at the most recent Board meeting, Ice Miller recommended changing the system again because of federal compliance concerns. Ms. Shipione also mentioned that the Municipal Code had been changed to allow the City to contribute to the pension system pursuant to a Memorandum of Understanding instead of actuarial funding.

June 6, 2006 Letter to the Audit Committee

Mr. Romano asked Ms. Shipione if the statement in her letter to him dated June 6, 2006 (Exhibit 8), that the City's FY 07 budget continues to underfund the pension system in violation of the principle of "intergenerational equity," was based on conclusions in the Navigant

Report. Ms. Shipione responded, "at least." She said she had also heard that term from outside counsel, perhaps in Robert Blum's June 12, 2002 letter.

Regarding the statement in her June 6, 2006 letter that the City's FY 2007 pension contribution was "an illegal loan" which "falsely balance[d] the budget," Mr. Romano asked her if she was referring to the fact that when the City does not pay its full pension contribution, it continues to owe the remaining amount. She confirmed that interpretation and noted that when she was on the Board, the Board was told not to use the word "loan," because such loans from SDCERS to the City would be illegal. She clarified that she was not at the meeting where the Board was instructed not to use the term "loan," but she had read this admonition in the Board minutes. She said that certain minutes from meetings during MP1 deliberations, which contained these comments, were re-distributed to the Board during its deliberations of MP2 in June 2002. Ms. Shipione did not know who re-distributed these minutes, and suggested it could have been staff, the system's outside attorneys, in-house counsel Lorraine Chapin, or Lawrence Grissom.

Mr. Romano then asked Ms. Shipione to explain her reference in the June 6, 2006 letter to Proposition G. Ms. Shipione stated that Proposition G dictated that the pension system should be funded in a certain manner, except in the event of a settlement of a lawsuit. Ms. Shipione believed that Proposition G also prohibited the actuary from including Corbett payments as a liability, even though it was her understanding that actuaries should include all liabilities in their valuations. Mr. Romano asked if the actuary was a party to the Gleason litigation, and she replied that he was not. Mr. Romano asked if the City's current-year pension contribution of \$162 million was ever brought before a judge. Ms. Shipione did not know the answer. She said that SDCERS would normally do experience valuations every three to five years, but that under the Gleason settlement, the City's contributions were determined using assumptions from 2003, which were generated from a 2001 experience valuation. Ms. Shipione explained that the experience valuations were supposed to "true up" actuarial assumptions with reality in order to get best estimates and prevent actuarial losses or gains. In Ms. Shipione's view, part of the problem with SDCERS was that the assumptions were being "gamed" intentionally, which, she said, was noted by Vinson & Elkins. Ms. Shipione said that the idea of freezing assumptions as was done in *Gleason* was a problem, and Mr. Blum previously had noted that it was potentially illegal to tie a future Board's hands. She was concerned that the settlement used dated assumptions to calculate the City's contributions.

Ms. Shipione said that a more up-to-date experience valuation was presented to SDCERS's new actuary in 2005, which covered the years up to 2004. Mr. Romano asked if she knew whether anyone opted out of the Gleason settlement class or pursued individual claims after the settlement, and Ms. Shipione replied that she did not know.

Mr. Romano asked Ms. Shipione to explain her comment in her June 6 letter that both the City's and SDCERS's disclosures were not in accordance with GASB and that the "continual restarting of the 30 year amortization" artificially lowered the City's contributions and understated its liabilities. She responded that she thought GASB would want SDCERS to report what it was doing, and to report all its assets and liabilities, though she was not certain that GASB prohibited the restarting of amortization periods. She noted that the amortization periods were fixed, not rolling, so a consistent approach would have been to pay each amount down over

the full amortization period. She also mentioned the switch from EAN to PUC, and said that her concern was not potential non-compliance with GASB, it was whether all liabilities had been included in valuations. She said it was her belief that the consistent application of GASB principles would be an appropriate approach, and it was necessary to include, for example, DROP assets and liabilities.

Mr. Turner asked Ms. Shipione why she waited until June to respond to the Audit Committee's letter requesting an interview with her. She said that her letter to the Audit Committee went through many iterations before she decided she should send it. Mr. Haegel asked if she had edited any information out of her letter that she now thought the Audit Committee should know. She said that she was confident that the information she provided in her letter "covered the full gamut." She said that the letter took her a long time to write because she has a full-time job, and had to write it in the middle of the night.

MP-2

Regarding Ms. Shipione's appearance before the Council on November 18, 2002, and her letter presented on that date protesting the adoption of MP-2, Mr. Romano asked her why she chose to deliver her letter on that date. Ms. Shipione replied that the SDCERS Board had only approved MP-2 a few days prior, on November 15. Mr. Romano asked if she considered November 15 to be the Board's "critical" meeting on MP-2, and she responded yes. She said that when the Board voted on July 11th, the meeting was supposed to have ended at a time certain (1 p.m.) and both she and Richard Vortmann had left before the vote. Later, when she discovered that the Board had voted, she wanted it to reconsider the item but was told not to worry because it was coming back up for a vote on November 15th. At the November 15th meeting, Ms. Shipione recalled being "taken aback" by Mr. Blum's comments regarding MP-2 and was "shocked" that the Board then approved MP-2. Mr. Turner asked her why she was surprised given the Board's vote in July, and she said she did not know, she just could not believe that the Board would say "yeah, sure, you [the City] don't have to put money in." Ms. Shipione recalled saying that it was not personal, but she felt the proposal was corrupt and thought the Mayor and Council should be made aware of her concerns because maybe they would address them.

Ms. Shipione stated that she was surprised no one asked her any questions after she spoke at the November 18th Council meeting, and thought it was because she was a poor public speaker. Her concern was that a day would come when the whole system would implode and years from now people will look back and ask her "what did you do?" and "who did you tell?"

Mr. Turner asked Ms. Shipione why she chose to remain on the Board with all the problems that she saw. Ms. Shipione said that when she joined the Board, the atmosphere was "jubilant," and looking back she can understand this was because MP-1 had just been approved. It took her a year to begin to understand how the system worked, and only then did she realize the irregularities in procedures and investments, and what she said were "hidden" elections of officers in violation of the Brown Act. Ms. Shipione noted that she and Ms. Webster had challenged these elections. She noted also that the minutes presented were not representative of the discussions that occurred during Board meetings. Ms. Shipione said that she had written

resignation letters on various occasions, but has never sent one. Every time she would write one, she said, another event would occur to which she felt she needed to respond. During her tenure, she continued to think that the City would react affirmatively to her concerns. For example, she thought that the City Manager was going to respond to her request for an audit of SDCERS; instead, he proposed MP-2. As her concern grew over time, she escalated her responses and contacted the Mayor, the Council, and eventually the public through the media. She said that she wanted to write the Attorney General and State Comptroller, but never did. Ms. Shipione said she continues to believe the City's financial condition is worse than it is represented.

Mr. Romano asked Ms. Shipione when she first learned of MP-1's trigger provision, and she replied that she could not recall. She stated that she became aware of SDCERS's declining investment performance over time, and recalled Mr. Roeder mentioning the trigger, perhaps in early 2002 Board meetings in discussions about the 2001 actuarial valuation. Mr. Romano asked if there was a sense that hitting the trigger would cause an urgent problem, and if that sense contributed to a desire to approve MP-2 quickly. Ms. Shipione replied that the rush in approving MP-2 was that an amendment needed to be made to MP-1 because benefits had already been granted in the 2002 Meet & Confer negotiations. The funding scheme needed to be changed before those benefits were to be paid. Ms. Shipione associated the hurry with the fact that there were conditional benefits granted in the Meet & Confer negotiations, and that she did not recall the rush to be specifically linked to a pending balloon payment.

Mr. Turner asked Ms. Shipione if she recalled hearing that the City would increase benefits, but in return it would receive funding relief. Ms. Shipione recalled that the budget was needed by July 1st, and the payroll needed to be set. She noted that in October, members were wondering whether they were going to get the enhanced benefits, so she wasn't the only person to see November as the final vote.

Mr. Shea stated that he believed the trigger issue was known by many people in the City, but not necessarily by the pension trustees. He said that the underfunding amount seemed to go from nothing to \$2 billion in six months. There were a series of articles in the Union Tribune demonstrating an increase in the underfunding, and said that people only started to pay attention when it was estimated at \$780 million.

Mr. Turner asked Ms. Shipione what she thought the level of underfunding was at the time she voted on MP-2, and she replied that she did not remember but did recall that when Mr. Roeder's June 2002 Report was released, the deficit had ballooned. Mr. Romano asked if she recalled a presentation in June or July discussing the effect of the trigger on the system's funding. Ms. Shipione said that she remembered a letter from Mr. Roeder in November which concluded that MP-1 was better for the system if the floor was hit. She noted that both the July and November Board meetings were "critical," and recalled that Mr. Roeder had discussed the trigger prior to June 2002, perhaps in an Earnings Subcommittee meeting in April. Ms. Shipione was not on this subcommittee, but believed that Mr. Pierce, Mr. Vortmann, and perhaps Ray Garnica were. She said the subcommittee made recommendations about how to handle surplus earnings, given that they would be low that year. She recalled that Mr. Roeder had concerns regarding the funded ratio, and that there was a general awareness that earnings were down and hitting the trigger was a possibility. Ms. Shipione did not know whether other people believed that the trigger had been hit in May or June 2002.

Mr. Romano commented that it appeared as though the trigger was not the driving force in her mind during the MP-2 deliberations. Ms. Shipione said that the Board continuing to underfund the pension plan was her main concern, and that she did not think that any of the agreements related to MP-2 were proper for fiduciaries to approve. At first, she pushed forward to "uncover the truth," to discharge her responsibilities as a trustee. She said she eventually approached the auditors with her concerns, and now, the Audit Committee. Ms. Shipione said she voted against MP-2 because it continued to underfund the pension system, because it allowed the City to avoid the balloon payment, and because it was conditioned upon the granting of benefits. She said that the normal process of funding a defined-benefit pension plan had become "corrupted."

Mr. Romano asked if she came to learn about presidential leave benefits, and Ms. Shipione said that she understood this was "cut on the side," and that she was not aware of this benefit when it was approved. Mr. Romano said the presidential leave benefits were granted through a resolution, not an ordinance, and asked if she knew the difference. Ms. Shipione replied that there was a difference between resolutions and ordinances, but she did not know the legal distinctions.

Mr. Turner asked Ms. Shipione why she never wrote a letter to Vinson & Elkins, to explain her views. Ms. Shipione replied that she was concerned Vinson & Elkins was representing the Council members against the SEC and DOJ. She said she was not sure what she could have contributed to their work. Ms. Shipione stated that at one point, it had dawned on her that it was not her job to determine what was legal or what the City should report; this was the job of the auditors. She said that she wanted to meet with the auditors because they are the last line of defense for the transmittal of accurate information to the public.

Mr. Turner said that he had learned of a fight with Mayor Murphy regarding an airport deal, and asked Ms. Shipione her response. She said she did not know much about airports or Brownfield. She said that the search for reality and truth was her driving motivation, and that the more she learned, the more it seems that nothing made sense. Ms. Shipione explained that the position of trustee was very important to her because she cared about the interests of the elderly. Mr. Shea commented that the reason the Brownfield deal lingers in San Diego is because people are cynical and cannot understand that someone like Ms. Shipione could be working so hard solely in the interest of the public.

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